Diverging Monetary Policies: Bad News for the Euro?

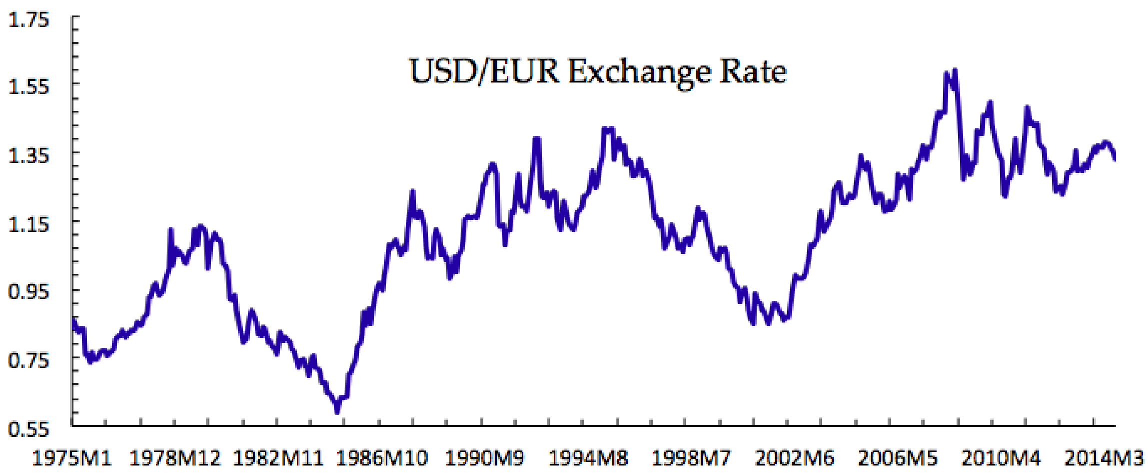
By Antonio Fatas , INSEAD Professor of Economics

As Europe moves to encourage spending and the US tightens its purse strings, what's the future for the euro?

With the U.S. Federal Reserve looking to raise interest rates and the ECB preparing to launch its quantitative easing plans, some see the potential for a large fall in the value of the euro – a decline that may already have begun.

Given there have been similar episodes of divergence in monetary policy (or at least a change in pace) in the past), it is interesting to check what happened during those episodes to give us an idea of what the future may hold.

Below is the evolution of the USD/EUR exchange rate since 1975 (click on the picture for a larger version). As the euro did not exist before 1999 I have replaced it with the German mark during the earlier period, converted at the mark/euro rate fixed at the time the euro was launched. So the chart is really a combination of the German/U.S. exchange rate before 1999 and the euro/US exchange rate post-1999.



The line drifts up mostly because inflation in Europe has consistently been below that of the U.S. (we expect the currency with the higher inflation to depreciate over time). The effect is more pronounced in the early decades when inflation differentials (between Germany and the U.S.) were the largest. In addition to the trend we see two episodes where the dollar strengthened substantially relative to the euro and then reversed in the opposite direction at a similar speed to go back towards its trend.

Diverging policies accelerate USD/EUR

The first episode was in the early 1980s when a combination of tight monetary policy and large budget deficits in the U.S. put upward pressure on interest rates and started a persistent swing upwards of the U.S. dollar. The U.S. dollar reached a value that was clearly above any reasonable estimate of fundamentals and led to the Plaza Accord in September 1985, when finance ministers from Europe, Japan and the U.S. agreed to intervene to keep the dollar from continuing its appreciation. The reversal that followed was also very dramatic.

The second episode took place in the mid to late 1990s coinciding with very strong growth rates in the U.S. that attracted the interest of investors. Monetary policy itself was not that different during this period but growth rates were. Plus we saw the 1999 launch of the euro, viewed by some as a source of uncertainty and potential bad news for the Euro economy and its currency. This time, the appreciation of the U.S. dollar was also stopped by a coordinated intervention of the U.S. Federal Reserve and the ECB in

November 2000.

Alternative scenario

In both of these episodes we can see a pattern of divergence in economic conditions between Europe and the U.S. triggering an appreciation of the U.S. currency (although not always related to monetary policy), and in both cases the appreciation led to overvaluation and large volatility. Can we expect a repeat of that pattern today? It is certainly a possibility, but far from guaranteed. Why? Because if we look carefully at some of the other periods when U.S. growth outpaced Europe's and U.S. interest rates were rising faster, the U.S. dollar did not appreciate. In fact, it depreciated significantly.

One example is the period 2002-2003 when Europe was in the middle of a recession with growth rates significantly lower than those of the U.S. Interest rates in Europe were coming down and remained at 2 percent until the fall of 2005. At the same time, U.S. interest rates were climbing from a low of 1 percent to 5.25 percent by the summer of 2006. In those years not only did the dollar not appreciate, but it depreciated relative to the euro (from below 0.9 USD/EUR in January 2002 to 1.30 USD/EUR by 2005.).

It is also interesting to note that since the 2008 crisis began, the USD/EUR exchange rate has remained relatively "stable" (compared to previous years) fluctuating between 1.25-1.40 despite the dramatic changes on both sides of the Atlantic.

What happens next?

If economic conditions continue to diverge between the U.S. and Europe, and the euro depreciates heavily relative to the U.S. dollar, no one will be surprised. It will clearly look like a great textbook illustration of the way interest rates and capital flows move currencies. But history tells us that there are no guarantees this will happen. Exchange rates are a lot more volatile and unpredictable than some theories would have you believe. Regardless of the final change in the exchange rate, it is very likely we will witness a lot more volatility ahead in contrast with previous years' stability.

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